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SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-68584; File No. SR-CBOE-2012-109)

January 4, 2013

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change Related to CBSX to Address the Authority to Cancel Orders When a Technical or Systems Issue Occurs and to Describe the Operation of Routing Service Error Accounts

I.   Introduction

        On November 16, 2012, the Chicago Board Options Exchange, Incorporated ("Exchange"

or "CBOE") filed with the Securities and Exchange Commission ("Commission"), pursuant to

Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a

proposed rule change to (i) address the authority of CBOE Stock Exchange, LLC ("CBSX",

CBOE's stock execution facility) to cancel orders (or release routing-related orders) when a

technical or systems issue occurs; and (ii) describe the operation of a CBSX error account(s) and

routing broker error account(s), which may be used to liquidate unmatched executions that may

occur in the provision of the CBSX's routing service. The proposed rule change was published

for comment in the Federal Register on November 26, 2012.[3] The Commission received no

comment letters regarding the proposed rule change. This order approves the proposed rule

change.

II.   Description of the Proposal

         In its proposal, the Exchange states that CBSX operates a system of trading that allows

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[1]   15 U.S.C. 78s(b)(1).

[2]   17 CFR 240.19b-4.

[3]   Securities Exchange Act Release No. 68265 (November 19, 2012), 77 FR 70511
        (November 26, 2012) (SR-CBOE-2012-109) ("Notice").

automatic executions to occur electronically.[4] As part of this infrastructure, the Exchange states

that CBSX automatically routes orders to other exchanges under certain circumstances. These

routing services are provided in conjunction with one or more routing brokers that are not

affiliated with CBSX.[5] Mechanically, when CBSX receives an order from a Trading Permit

Holder that is held in the CBSX system and determines to route an order to another exchange,

CBSX provides the routing broker with a corresponding order and instructions to route the order

to another trading center. The routing broker then sends the corresponding order to the other

trading center.

In its proposal, CBOE states that CBSX may encounter situations that make it necessary

to cancel orders (or release routing-related orders), [6] and to resolve error positions that result

from errors of the Exchange, routing brokers, or another exchange.[7]

Proposed Rule 52.3A (Order Cancellation / Release)

New CBOE Rule 52.3A provides CBSX with general authority to cancel orders as it

deems to be necessary to maintain fair and orderly markets if a technical or systems issue occurs

at CBSX, a routing broker in connection with the routing service provided under CBOE Rule

52.10, or another trading center to which a CBSX order has been routed. It also provides that a

routing broker may only cancel orders being routed to another trading center based on the

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[4]   See Notice, 77 FR at 70511.

[5]   See Notice, 77 FR at 70511-12 n.4, n.8, and accompanying text.

[6]   See Notice, 77 FR at 70512. For examples of some of the circumstances in which
the Exchange may decide to cancel orders, see Notice, 77 FR at 70512-13.

[7]   See Notice, 77 FR at 70512. Specifically, CBOE Rule 52.10A defines "error positions"
as "unmatched trade positions that may occur in connection with the routing service
provided under Rule 52.10".

For examples of some of the circumstances that may lead to error positions, see Notice,
77 FR at 70514.

CBSX's standing or specific instructions or as otherwise provided in the Exchange Rules. CBSX will be required to provide notice of the cancellation to affected Trading Permit Holders as soon as practicable.[8]

Paragraph (b) of the rule provides that CBSX may also determine to release orders being held on CBSX awaiting another trading center execution as it deems to be necessary to maintain fair and orderly markets if a technical or systems issues occurs at CBSX, a routing broker, or another trading center to which an order has been routed. Paragraph (c) of the rule provides that, for purposes of Rule 52.10A, technical or system issues would include, without limitation, instances where CBSX has not received confirmation of an execution (or cancellation) on another exchange from a routing broker within a response time interval designated by the Exchange, which interval may not be less than three (3) seconds. In conjunction with this proposed rule change, CBOE also proposed to amend CBOE Rule 52.7 which provides, in part, that an Intermarket Sweep Order ("ISO") shall be generated if an order that is entered on CBSX would lock or cross a protected quotation in an away market, to provide that if CBSX does not receive any response at all to an outbound ISO, at the expiration of the response time internal , CBSX will release the corresponding order that had been suspended on the CBSX Book pending the response to the ISO in accordance with Rule 52.3A.

Proposed Rule 52.10A (Routing Service Error Accounts)

New CBOE Rule 52.10A provides that each routing broker shall maintain, in the name of the routing broker, one or more accounts for the purpose of liquidating error positions. In addition CBSX may also maintain, in the name of CBSX, one or more CBSX error accounts ("CBSX Error Account") for the purposes of liquidating error positions, subject to the

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[8]   See CBOE Rule 52.3A(a).

procedures prescribed in new CBOE Rule 52.10A.

Paragraph (a) of the rule provides that errors to which the rule applies include any action or omission by CBSX, a routing broker, or another trading center to which a CBSX order has been routed, that results in an unmatched trade position due to the execution of an order that is subject to the away market routing service and for which there is no corresponding order to pair with the execution (each a "routing error"); and that such routing errors would include, without limitation, positions resulting from determinations by CBSX to cancel or release an order pursuant to CBOE Rule 52.3A.

Paragraph (b) of the rule provides that, generally, each routing broker will use its own error account to liquidate error positions. In certain circumstances, however, CBSX may use a CBSX Error Account. In particular, in instances where the routing broker is unable to use its own error account (e.g., due to a technical, systems or other issue that prevents the routing broker from doing so)[9] or where the error is due to a technical or systems issue at CBSX, CBSX may (but would not be required to) determine it is appropriate to use a CBSX Error Account. The Exchange states that in making such a determination to use a CBSX Error Account, the CBSX would consider whether it has sufficient time, information and capabilities considering the market circumstances to determine that an error is due to such circumstances and whether the Exchange can address the error.[10]

Pursuant to paragraph (c), CBSX will not be permitted to accept any positions in a CBSX Error Account from an account of a Trading Permit Holder or permit any Trading Permit Holder to transfer any positions from the Trading Permit Holder's account to a CBSX Error Account. In

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[9]   See Notice, 77 FR at 70513.

[10]   See id.

other words, CBSX may not accept from a Trading Permit Holder positions that are delivered to the Trading Permit Holder through the clearance and settlement process, even if those positions may have been the result of an error.[11]

To the extent a routing broker uses its own account to liquidate error positions, paragraph (d) of new CBOE Rule 52.10A provides that the routing broker shall liquidate the error positions as soon as practicable. The routing broker could determine to liquidate the position itself or have a third-party broker-dealer liquidate the position on the routing broker's behalf. Paragraph (d) also provides that the routing broker shall establish and enforce policies and procedures reasonably designed to (i) adequately restrict the flow of confidential and proprietary information associated with the liquidation of the error position in accordance with Rule 52.10,[12] and (ii) prevent the use of information associated with other orders subject to the routing services when making determinations regarding the liquidation of error positions. In addition, paragraph (d) provides that the routing broker shall make and keep records associated with the liquidation of such routing broker error positions and shall maintain such records in accordance with Rule 17a-4 under the Act.[13]

Paragraph (e) of the rule provides that, to the extent a CBSX Error Account is used to

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[11]   See Notice, 77 FR at 70513 n.17. This provision would not apply if the Exchange incurred a position to settle a Trading Permit Holder purchase, as the Trading Permit Holder did not yet have a position in its account as a result of the purchase at the time of the Exchange's action. See id.

[12]   Rule 52.10.01(c) provides that CBSX shall establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between CBSX and the routing broker (referred to in the rule as the "Technology Provider"), and, to the extent the routing broker reasonably receives confidential and proprietary information, that adequately restrict the use of such information by the routing broker to legitimate business purposes necessary for the licensing of routing technology.

[13]   17 CFR 240.17a-4.

liquidate error positions, CBSX shall liquidate the error positions as soon as practicable. In

liquidating error positions in a CBSX Error Account, CBSX shall provide complete time and

price discretion for the trading to a third-party broker-dealer and shall not attempt to exercise any

influence or control over the timing or methods of such trading.[14] Such a third-party broker-

dealer may include a routing broker not affiliated with CBSX. Paragraph (e) also provides that

CBSX shall establish and enforce policies and procedures reasonably designed to adequately

restrict the flow of confidential and proprietary information between CBSX and the third-party

broker-dealer associated with the liquidation of the error positions.

Finally, paragraph (e) provides that CBSX shall make and keep records to document all

determinations to treat positions as error positions under the rule (whether or not a CBSX Error

Account is used to liquidate such error positions), as well as records associated with the

liquidation of CBSX Error Account error positions through a third-party broker-dealer, and shall

maintain such records in accordance with Rule 17a-1 under the Act.[15]

III.   Discussion and Commission's Findings

After careful review, the Commission finds that the proposed rule change is consistent

with the requirements of Section 6(b) of the Act[16] and the rules and regulations thereunder

applicable to a national securities exchange.[17] In particular, the Commission finds that the

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[14]   This provision is not intended to preclude the Exchange from providing the third-party broker-dealer with standing instructions with respect to the manner in which it should handle all error account transactions. For example, the Exchange might instruct the broker-dealer to treat all orders as "not held" and to attempt to minimize any market impact on the price of the option being traded.

[15]   17 CFR 240.17a-1.

[16]   15 U.S.C. 78f(b).

[17]   In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

proposed rule change is consistent with Section 6(b)(5) of the Act,[18] which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. In addition, the Commission believes the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act[19] in that it seeks to assure economically efficient execution of securities transactions.

The Commission recognizes that technical or systems issues may occur, and believes that CBOE Rule 52.3A, in allowing CBSX to cancel or release orders affected by technical or systems issues, should provide a reasonably efficient means for CBSX to handle such orders, and appears reasonably designed to permit CBSX to maintain fair and orderly markets.[20]

The Commission also believes that allowing CBSX to resolve error positions through the use of error accounts maintained by its routing brokers or CBSX itself pursuant to the procedures set forth in the rule, and as described above, is consistent with the Act. The Commission notes

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[18]   15 U.S.C. 78f(b)(5).

[19]   15 U.S.C. 78k-1(a)(1)(C).

[20]   The Commission notes that CBSX states it believes that allowing it to cancel or release orders under such circumstances would allow CBSX to maintain fair and orderly markets, and that CBOE Rule 52.10A is designed to ensure full trade certainty for market participants, and avoid disrupting the clearance and settlement process. See Notice, 77 FR at 70514. The Commission also notes that CBOE states that a decision to cancel or release orders due to a technical or systems issue is not equivalent to CBSX declaring self-help against a routing destination pursuant to Rule 611 of Regulation NMS. See 17 CFR 242.611(b). See also Notice, 77 FR at 70512 n.9.

that the rule establishes criteria for determining which positions are error positions to which the

rule applies, and the procedures for the handling of such positions. In particular, the

Commission notes that CBOE Rule 52.10A only applies to error positions that result from the

Exchanges routing service, and that such positions shall be liquidated by the routing broker or

the Exchange, as applicable, as soon as practicable.[21] In this regard, the Commission believes

that the new rule appears reasonably designed to further just and equitable principles of trade and

the protection of investors and the public interest, and to help prevent unfair discrimination, in

that it should help assure the handling of error positions will be based on clear and objective

criteria, and that the resolution of those positions will occur promptly through a transparent

process.

The Commission is also concerned about the potential for misuse of confidential and

proprietary information. The Commission notes that CBSX or a routing broker, as applicable,

will establish and enforce policies and procedures reasonably designed to (1) adequately restrict

the flow of confidential and proprietary information associated with the liquidation of the error

positions, and (2) in the case of liquidations by a routing broker, prevent the use of information

associated with other orders subject to the routing services when making determinations

regarding the liquidation of error positions.[22] Furthermore, to the extent CBSX uses a CBSX

Error Account to liquidate error positions, the Exchange shall provide complete time and price

discretion for the trading to liquidate error positions in a CBSX Error Account to a third-party

broker-dealer and shall not attempt to exercise any influence or control over the timing or

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[21] See CBOE Rule 52.10A.

[22] See CBOE Rules 52.10A(d)(i); 52.10A(e)(ii).

methods of such trading.[23] The Commission believes that these requirements should help

mitigate the Commission's concerns. In particular, the Commission believes that these

requirements should help assure that none of CBSX, its routing brokers, or any third-party

broker-dealer is able to misuse confidential or proprietary information obtained in connection

with the liquidation of error positions for its own benefit. The Commission also notes that

routing brokers would be required to make and keep records associated with the liquidation of

routing broker error positions[24] and CBOE would be required to make and keep records to

document all determinations to treat positions as error positions under this Rule (whether or not a

CBSX Error Account is used to liquidate such error positions), as well as records associated with

the liquidation of CBSX Error Account error positions through a third-party broker-dealer.[25]

Finally, the Commission notes that the proposed procedures for canceling orders and the

handling of error positions are consistent with procedures the Commission has approved for

other exchanges.[26]

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[23] See CBOE Rule 52.10A(e)(i).

[24] See CBOE Rule 52.10A(d)(ii).

[25] See CBOE Rule 52.10A(e)(iii).

[26] See, e.g., Securities Exchange Act Release Nos. 67281 (June 27, 2012), 77 FR 39543 (July 3, 2012) (SR-NASDAQ-2012-057); 66963 (May 10, 2012), 77 FR 28919 (May 16, 2012) (SR-NYSEArca-2012-22); 67010 (May 17, 2012), 77 FR 30564 (May 23, 2012) (SR-EDGX-2012-08); and 67011 (May 17, 2012), 77 FR 30562 (May 23, 2012) (SR-EDGA-2012-09).

IV.   Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[27] that the proposed rule change (SR-CBOE-2012-109) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[28]

Kevin M. O'Neill
Deputy Secretary

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[27]   15 U.S.C. 78s(b)(2).

[28]   17 CFR 200.30-3(a)(12).